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SUBJECT: BOSNIA: GLOBAL FINANCIAL CRISIS IN BOSNIA

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¶11. Summary: The Global Economic Crisis has reached Bosnia as demand for key exports, such as metals, has fallen sharply, construction has stalled and Foreign Direct Investment (FDI) has dropped. Loans are hard to get and remittances have stopped growing. Nonetheless, Bosnia's high percentage of public spending and remittances combine to insulate almost two thirds of GDP from the economic storm and positive GDP growth is still expected. A sad casualty, however, may be the economic health of the Srebrenica region, which has been the focus of much effort to improve the economic prospects for its citizens. Srebrenica's key employer, the SASE lead and zinc mine has announced that it will lay off 200 employees. While Bosnian political leaders have expressed concern about the possible impacts of the economic crisis, their options for interventions are limited.

End Summary.

COMMODITIES TAKE THE FIRST HIT

¶12. Although the macroeconomic data has not been published for the fourth quarter of 2008, Bosnia and Herzegovina has clearly begun to feel the impacts of the falling economies among its trading partners, particularly as global demand for raw materials declines, leaving large exporters such as Aluminij and Mittal Steel with fewer orders. In addition to Aluminij and Mittal Steel, smaller exporters including car spare parts manufacturers, composite metal and textile firms indicated slowing external demand. (Metals are a key sector for Bosnia, making up roughly 25% of the country's exports and providing thousands of well-paying jobs.)

¶13. In December, the country's only aluminum smelter plant and its largest exporter, Mostar-based Aluminij, announced that it will cut its output by a quarter in 2009. Plant leaders tried to pin most of the blame on its ongoing dispute with the Federation Parliament's refusal to provide &preferential pricing⁸ for its electricity needs in order to lower its overhead costs. Aluminij officials also admitted that low global metal prices also affected its decision to reduce output. Aluminij employs 970 people and will likely face layoffs this year based on its reduced output. Mostar region companies who depend on the plant have already claimed that 700 jobs are at risk.

¶14. Similarly, Mittal Steel has announced that it will cut costs and production as well as up to 9,000 jobs worldwide due to falling demand and prices for steel. They have not announced that any layoffs or production cuts will occur in Bosnia (as yet), but the pressures are real.

OTHER SIGNS OF TROUBLE

15. The country's largest engineering group, Energoinvest, saw its pre-tax profits fall by 25 percent in 2008. The company noted that its profits fell particularly in the fourth quarter of 2008, admitting that the global financial crisis affected its success in securing contracts, notably in the Middle East and Africa.

--In the RS, wood industry officials have threatened to lay off 2,000 workers unless they receive help from the RS Government.

-- The World Bank predicts that capital inflows and foreign direct investment will continue to decrease in 2009, on top of already significant decrease in 2008) figures as of November 2008 showed a drop in FDI in Bosnia to 598 million Euros for the year to date. (One Euro is roughly \$1.35). This is a significant decline from the 1.63 billion Euros of FDI in 2007, which included the key privatization of Telecom Srpska.

-- Economists predict that remittances, which make up the equivalent of 17 to 18 percent of GDP, will remain flat this year in contrast to recent growth of as much as 9 percent per year. Embassy Sarajevo's consular section has already noted a decline in requests for visas, likely reflecting a decrease in funds from American citizens of Bosnian descent sending travel funds to BiH relatives.

-- Partly caused by a speculative bust at the start of the year, the stock markets in both the Federation and the RS plunged by 65 percent in 2008, the RS market tumbled to its

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initial levels when the Banja Luka exchange opened in 2002.

-- The World Bank also predicts that lending by banks will remain tight. Parent banks in Austria and other countries that dominate banking in Bosnia have stopped for at least six more months providing additional capital to their subsidiaries in Bosnia. This means that new loans can only be made with the limited income from existing loans.

-- The construction sector, which in past years has grown as much as 33 percent per year, did not grow at all in the final months of 2008 and is expected to even decline in 2009. One exception and a possible source of economic stimulus is road construction. The World Bank estimates that Bosnia's road construction firms are already working at near to full capacity. The recently approved 600 million Euro project that will build four additional segments of corridor 5C funded by the European Bank for Reconstruction and Development, the European Investment Bank and the Federation (Ref A) will provide a timely additional infrastructure project.

RESULTS OF GLOBAL CRISIS OR GREATER EUROPEAN INTEGRATION?

16. Not all bad economic news is due to the slowdown. Volkswagen Sarajevo announced in December that it will lay off 70 of its 390 workers. The contract workers will be the first to be laid off, although longer-term employees could also face cuts. Volkswagen (Germany) owns 58 percent of Volkswagen Sarajevo, while local firm Prevent BH owns the remainder. The company manufactures car parts for VW in Germany. Although the local media immediately blamed the global financial crisis and the reduced global demand for vehicles for the layoffs, signing of the Stabilization and Association Agreement with the European Union is the likely culprit. The tariff-free import regime, introduced last year with the signing of the interim SAA, allows VW to import vehicles for sale in Bosnia, versus the previous arrangement where they imported kits that were assembled and finished in

Bosnia, avoiding the former higher tariff rates on fully-assembled cars.

CENTRAL BANK OFFICIALS RESPOND

17. The Central Bank announced on December 18 that Bosnians have withdrawn 800 million KM (about \$550 million) from commercial banks since the start of the commercial crisis, up from 550 million KM that had been withdrawn by the end of October (Ref B), proving that the initial trend of withdrawals has slowed. Central Bank Governor Kemal Kozari also noted that 100 million KM in new deposits have been made in December, signaling a return of consumer confidence in the banking system. Kozaric also announced that the Central Bank will further lower the reserve requirement rate for deposits with a maturity of over one year to 10 percent. In mid-October, the Central Bank had lowered the reserve requirement from 18 to 14 percent (Ref B).

SREBRENICA: AN UNFORTUNATE CASUALTY

18. SASE Mine, the Srebrenica area's largest employer, announced 200 layoffs last week according to USAID's Srebrenica economic advisor and the local media. The lead and zinc mine employed 370 before the layoffs and is the core of the economy in the Srebrenica region. In addition, a former success story, CIMOS, a Slovenian car parts manufacturer that has brought over a hundred jobs to the challenged community, has been facing a serious drop in car parts orders due to the global downturn. After a 15-day forced holiday, the producer continued with their regular production on January 8, thanks to new orders for construction products from Belgium. Although they are not facing immediate layoffs, they have already introduced a wholesale salary cut of 10 percent. These developments have undercut Embassy Sarajevo's and others efforts over the past year and a half to improve the economic situation in Srebrenica. There have even been anecdotal stories of local bakeries that have been giving out bread for free to needy families) poverty that has not been witnessed in other parts of the country.

MAYBE ALL THAT GOVERNMENT SPENDING HAS A GOOD SIDE

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19. World Bank economist Orhan Niksic reviewed the Bosnian economic situation with Econoffs on January 6. He predicts that Bosnia's GDP growth in 2009 will stay positive in the 3 percent range. This would be less than the 5-6 percent growth of the last several years, but, in the current circumstances worldwide, a good performance. Niksic observed that about two thirds of the Bosnian economy is insulated from the crisis to a degree because of the country's very high public spending of roughly 50 percent of GDP and the 17-18 percent of GDP provided by remittances. Bosnia's high public spending has long been criticized by the IMF and others, but, in the current circumstances, (and as long as the government resources remain available) the spending is helping to keep the economy operating and serves as a de facto stimulus program.

LIMITED GOVERNMENT INTERVENTION OPTIONS

110. Bosnian political leaders are at least paying attention to the crisis, but have no coherent strategy for dealing with it. Council of Ministers Chairman Nikola Spiric has asked the World Bank for an analysis of the potential impacts on

Bosnia, but the state-level government has done essentially nothing to date. Federation Prime Minister Brankovic has met with business leaders at least twice. The second meeting, held late last month, resulted in what appears on the surface to be a comprehensive economic recovery and reform plan. Key elements of the plan include cutting the burden on employers for social payments for health care, unemployment, and pensions. To that end, the plan has a target of a 3.5 percent reduction in wage contributions by the end of the first quarter of 2009 and a 15 percent reduction by 2012. The plan also calls for making loans available for domestic companies, shifting Federation government spending on, for example, veterans to infrastructure projects, etc. Implementing the plan, however, will take political will and determination (and legislation) that has yet to be seen in the Federation on economic issues. In addition, the Federation's tight budget situation does not leave much room for maneuver.

¶11. In the RS, Prime Minister Dodik, is putting on a brave face and does have the luxury of significant extra budget resources from earlier privatizations) especially the proceeds from the sale of Telecom Srbska. In a recent statement to Serbian media, he said &We are not facing the crisis with an empty budget.⁸ . . . &Our chance lies in the fact that we did not overstretch our debt, and that this economy is based on patriotism. Here, you work not only to make money, but because you love the RS. That is why no one will be hungry.⁸ Dodik has not, however, announced any new specific programs to counter the crisis in the RS.

¶12. The international donor community has offered some support to Bosnia. EBRD has increased its loans to microcredit organizations in order to keep credit available to small and medium enterprises. The European Union has established a 120 million Euro &Crisis Response Package⁸ for South Eastern Europe that Bosnia could draw upon for specific programs) especially ones designed to support small and medium enterprises. The World Bank has also offered the Federation a 30 million Euro loan for programs to counter the crisis (conditioned on fiscal reforms).

Early Days

¶13. Comment. The crisis is hitting Bosnia now and will continue to do so as it unfolds across the world. If the World Bank is correct, Bosnia may avoid going backwards into a recession. Local impacts such as in Srebrenica, however, could fuel already sensitive political tensions. Lacking a comprehensive country-wide strategy from their governments, Bosnians will likely just have to go along with the economic ride. End Comment.

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